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Starwood Property Trust (STWD) 1Q20 Update
Maintain BUY

We are **maintaining our BUY recommendation on STWD** after 1Q20 results. Several positives and safety features were evident in the results and STWD sped up its earnings release to report strong results and outlook. Core EPS of 55-cents was higher than each quarter of 2019. As we noted in our original report, we think Dr. Malkiel would have a difficult time justifying that STWD is an efficiently traded stock. The reason STWD remains a hidden gem despite many positives is it trades in Mortgage REIT ETFs. When people are scared about NLY or AGNC – they sell the ETFs that also own STWD, which gets hit regardless of its positives. In discussing whether to buy back its own stock at lower levels this quarter, Barry Sternlicht noted this week, *"It seems like not the smartest thing to buy back stock and to hopefully wait for the stock to recover to levels on its own. We can't fight these ETFs, and it's simply just a waste of energy and capital."*

STWD has the liquidity and desire to pay its dividend as it paid 1Q's dividend in April. Keep in mind that many of the greatest deals this group has done, happened in periods of extreme market dislocation. As a result, the company added that it is keeping its flexibility available at the moment and noted:

> "*So I think we're feeling the book (value) is very safe. And I should talk for a second about the dividends. Our dividend policy will follow the philosophy of safety for the company.* ***Can we earn our dividend? Yes. Should we pay it out?*** *We're going to decide as the future unfolds.* ***So, we will wait till June to see how the year looks.*** *What's happened to the return of the economy? How our borrowers are fairing?... Signs are good, and we sent all this cash. So, we're going to do the prudent thing, and make sure that* ***obviously as a major***

shareholder, myself, I would like us to pay the maximum dividend we can, but we are here for the long run *and that will be a Board decision."*

In a show of support that it does think the stock is cheap, the company reported its manager group will take its base management fees of $19 million in stock. We believe the book value is understated here and STWD has a very conservative approach to investing and long-term value should be unlocked:

- **The commercial market for STWD's loan book simply is not in tatters. The biggest fear in March and April was whether office buildings would make their mortgage payments. STWD received all interest and payments due from over 99% of all borrowers in April.**
    - STWD's Loan to Value is only 61%
    - That is a safety feature by itself as the company notes this isn't 2008 where borrowers owed more than the property was worth, if you have 40% equity, you're going to pay the mortgage.
    - STWD also evaluates who its borrower's tenants are. The biggest source of weakness in office buildings it sees are shared space – where many 1-3 man shops occupy several floors.
    - Hotels have some problems, but the bulk of STWD's loan book is paying the mortgage notes.

- **Its property segment continues to outperform all expectations. 95% of the rent was paid in April here too. They have chosen unique properties carefully:**
    - The apartments in Florida have the rent tied to income levels and growth in the area. They expected 1%-2% growth in rents. Instead, they just received a 5% rent increase on top of 4% hikes in the prior years.
    - Once the rent increases, it cannot fall in these properties. Thus, the cash flow stream is rising.
    - At the same time, the cost of financing these properties is declining as STWD as refinanced them multiple times. The cash on cash yield is 14.6% now.
    - They are currently refinancing one of these properties again – it will increase cash liquidity for STWD by $85 million and lower borrowing costs by 100bp. So, the cash on cash return is going up again.
    - Occupancy at 97% and rising cash flows should indicate that the value of this property is increasing. Yet, depreciation has reduced STWD's

book value by $1.18 per share. This is a great undervalued asset on their balance sheet in our opinion.

- **LNR – the mortgage servicing unit is beginning its ramp-up. This unit deals with troubled mortgage loans and earns fees to amend terms, refinance debt, repossesses property and/or resell it. It is a great source of income that comes in during troubled times**
  - STWD bought this after the 2008-09 issues as its business was slowing – that was by design as it was cheap.
  - STWD noted that the business has accelerated for LNR, "*Our special servicer has not been busier in the seven plus years we have owned LNR. We have onboarded over 500 loans since COVID-19 representing over $14 billion in assets."*
  - "We shifted a bunch of assets (staff) over to that side (LNR) because the servicers now overwhelmed with requests for forbearance, particularly in the hotel space."
  - This source of income may start to appear in 2Q20 but will build throughout the year and 2021. The bigger fees come from restructuring loans and working with the asset beyond granting a short-term interest deferral.
  - Barry Sternlicht summed it up well, "*So it's early in the lifecycle. The servicer company once made hundreds of millions of dollars. While it's been exciting, it probably would mean that we've faced more issues on some of our hotels on the other side of the house. So, we're happy here where we are, and it's nice to see that revenue stream increase, but don't think of it as a massive windfall yet. It's just a hedge against everything else we do."*

- **Interest Rate Floors are helping protect income as the rates decline. We have been noting that STWD's EPS is set up to increase even as rates fall because of this.**
  - Over 90% of the loans on the books have LIBOR floors now.
  - STWD estimates it has $90 million in gains on these floors and another $50 million in gains in FX hedges on International loans.

- **All the work on the financing side of the balance sheet is paying off now as it is preserving liquidity with $870 million available – normally they operate**

with much lower levels of cash as that is a drag on their results, but right now it's an asset.

- We talked in past notes that STWD had always diversified its financing and spent much of 2019 boosting that process with the sale of A-notes, securitizations, and even CLOs.
- The net result is it has longer-term maturities and unencumbered assets (which can be used to boost collateral on other financings or sold to generate more liquidity) on the balance sheet. When credit spreads widen and asset values decrease, they are not facing calls on their short-term borrowing to put up more capital.
- Their size and credit rating offsets some of the incrementally higher rates paid to have fixed-rate debt on longer terms. But enhanced liquidity has value too.
- They continue to focus at this time on A-notes over warehouse lines. Basically, STWD wants to lock in the asset and funding for a longer time on any deals they look at in the current market.
- Their hotel loans are a case in point. STWD is working with $1.5 billion in hotel-related loans on $1.0 billion in warehouse loans. Its liquidity situation allowed it to prepay the warehouse lines and get bank agreement on 94% of the loans in question to allow it to modify loans where needed over the next 6-9 months without having margin calls.
- STWD has hotels with LTVs in the 60s, many newly renovated, and part of the larger flagship companies. It has the ability to grant items like using maintenance fees for debt servicing, closing hotels entirely to save operating costs, and defer rent for a period of time. It also allows time to restart the hotels and modify further as they see how the rest of 2020 plays out. STWD is not forgiving interest but is extending loan terms. It has already made its payments on the warehouse lines and is in a position to allow the hotels to reopen and resume payments without dealing with margin calls.
- This emphasis on the right side of the balance sheet is why STWD also made a comment on the call that while it doesn't want to fight the ETFs that hold its stock – buying back some of its own debt where it finds it is trading too cheaply may be an area it examines more than repurchasing stock.

- **Mark-to-Market hits under the new accounting rules requiring loss reserves to be based on third party modeling data over the life of loan demonstrates STWD's conservatism**
    - Adoption of these rules actually lowered the LTV ratio beyond what STWD was estimating in January. STWD was frequently about 64%-65% and in the new CECL rules said it was 59%. CECL now sets the LTV at 61%.
    - One of the loans that STWD internally rated very low in 4Q19 was repaid at par and reversed a $3 million loss reserve in 1Q20.
    - Two grocery distribution centers have been leased to a new tenant in 1Q also on a long-term deal that could produce a $50 million positive swing in reversing loss reserves and booking gains.
    - Setting up the new CECL loss reserve in January did not impact earnings but was charged against book value for $32 million. In March, reserves were boosted again by $49 million for CECL – 17-cents in EPS.
    - Mark-to-Market losses were another 58-cents in EPS in the 1Q20 and were driven by credit spreads widening. As we noted in the ARCC update, credit spreads have already declined about 300bp and with STWD reporting assets at fair value – it could see some of the mark-to-market declines recover.
    - These MTM hits do not have cash impacts unless the security is sold at the time. STWD has not had any forced sales and expects to hold many of these assets long term.
    - The positive liquidity situation also reduces the risk that any of these assets need to move in a fire-sale.

- **STWD plans to go on offense and buy more assets at higher yields**
    - LNR may end up bringing some deals to it.
    - They have no intention of selling equity at 70% of book value to finance anything. STWD plans to lock up financing with A-notes or some other type of longer-term instrument.
    - In some cases, volume has been hard to find, but STWD noted a few times on the call it is buying loans that it believes are being mispriced due to market stress.

Jeff DiModica, the President summed up the situation at STWD well:

*"**We are confident enough in our excess liquidity position that we have in fact recently gone on the offensive and begun investing capital selectively at extremely attractive level.** We moved our earnings call up three days this week to provide more information to the market earlier and heard that people think we did so to allow us to come to market quickly to raise capital. That is not our plan. **We have no need or plans given our excess liquidity to raise debt or equity capital in the near future, absent an unforeseen opportunity."***

Explanation of EQ Rating Scale

Rating	Description
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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